

Insurance Accounting Newsletter Conceiving the first global GAAP



IASB and FASB February meetings kick off the deliberations for the new accounting standard on insurance contracts.

Background

Some might say the International Financial Reporting Standard for Insurance Contracts (IFRS 4) has already had a long journey though there is undoubtedly still a fair way to get to completion. Nevertheless, with the extensive background preparation, consultation and education that has been undertaken, we can see some light at the end of this tunnel – meetings of both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in late February are positive steps towards the first combined IASB/FASB accounting standard for insurance – the first global GAAP. This is the first in a series of newsletters that will provide an update on the development of the new accounting requirements and a summary of Deloitte's own understanding of the progress being made by the IASB and FASB (the Boards).

Phase I of the IASB insurance contract produced the current version of IFRS 4 which has been in place since March 2004.

Subsequent to that milestone, the IASB began its Phase II of the insurance project which produced a Discussion Paper on its preliminary views on a comprehensive revision of IFRS 4 (May 2007).

In this document the IASB proposed to adopt a current exit value approach to insurance accounting. The Discussion Paper attracted an extensive number of comments and suggestions (more than 160 comment letters received) which the IASB analysed and discussed in the course of last year.

During 2008, FASB had also been considering whether to fundamentally change US GAAP for insurance accounting. Last October they decided to join in with the IASB on their insurance accounting project adding much needed resources to see the project to a conclusion.

The Boards met respectively on 18 and 25 February 2009; the same agenda papers were discussed in both meetings. This parallel work of the Boards is the beginning of an intensive season of meetings scheduled throughout 2009 with the aim of publishing an Exposure Draft in December this year. There would be a five month consultation period and the current timeline suggests the publication of an IFRS and a US GAAP standard for insurance in May 2011, which would be identical or substantially similar. Deloitte estimates that the earliest implementation date of the new requirements is likely to be 1 January 2013.



Outcome of the February 2009 IASB and FASB meetings

The main topic for consideration at the February Boards' meetings was the direction that will inform the choice for the new approach to account for insurance contracts. The Boards were asked to express their views on two key questions:

- whether the new accounting standard should be developed using a Current Exit Price (CEP) or a Current Fulfilment Value (CFV) approach to measure insurance liabilities; and
- whether or not an accounting profit could be recognised on the sale/inception of an insurance contract.

The IASB members did not reach a clear consensus on the choice of the measurement objective with only a small majority of six favouring the development of an IFRS based on the CFV approach, against five members still supporting the CEP presented in the 2007 Discussion Paper. Three IASB members are still undecided on the choice at this stage of the debate, pending the discussion on other important aspects of the new accounting standard.

On the other hand, the majority of FASB members (four out of five) were in favour of exploring the CFV approach rather than using a CEP, which they deemed very similar, if not identical, to the fair value measurement approach in FAS 157, *Fair Value Measurements*.

The Boards agreed they would not allow recognition of an accounting profit at the point of sale of an insurance contract, and that its initial measurement would have to be calibrated to the premium. This decision, which will be revisited in one of the Boards' future meetings, was reached assuming a scenario where the insurer had not incurred acquisition expenses.

In addition to the two fundamental issues discussed above, the Boards considered whether the measurement approach used in the new accounting standard should have the following four requirements:

1. estimates of financial variables should be as consistent as possible with observable market prices;
2. use and report explicit current estimate of expected (i.e. probability weighted) cash flows;
3. apply discounting in all cases; and
4. include an explicit margin.

The FASB discussed these requirements in the context of their preference for a CFV approach. However, because CFV is not a defined measurement under US GAAP, FASB members were not able to reach more robust conclusions at its meeting. Nevertheless, they agreed that a CFV approach would not require an insurance company to have all its estimates of the variables affecting the insurance contracts cash flows on a market consistent basis.

Because of the difficulties in reaching a consensus around the selection of the measurement objective, the IASB instead focused on the characteristics and requirements of the approach, on the grounds that they would apply to both the CEP and CFV, and tentatively agreed that the new IFRS should include them all.

Market consistent estimate of financial variables

The IASB accepted that both the CEP and CFV approaches should use estimates of variables which can be observed directly from market prices. The key financial inputs to be selected from observable market prices are the rates to be used for discounting, which are based on observed market interest rates. At one of its future meetings, the Boards plan to discuss the attributes of

the discount rates (e.g. that the discount rates should be selected with reference to market interest rates with the same currency and duration as the cash flows from the associated insurance contracts).

The IASB also clarified that the market consistency requirement would only apply to market prices and not extend to other information available to all market participants.

For example, when estimating cash flows associated with insurance risk, the insurer would be required to consider publicly available mortality tables in conjunction with other information specific to the portfolio of in-force insurance contracts the insurer holds (e.g. its own underwriting and claims experience from that particular portfolio of contracts).

The IASB was divided on the approach to be taken on the estimate of expenses related to insurance contracts' obligations (e.g. claims handling expenses or policy administration expenses). A number of members favoured the Discussion Paper approach that required an insurer to adjust its estimates for future expenses to eliminate any efficiency or inefficiency that would not be shared by all market participants. IASB members who support the CFV approach were against eliminating efficiencies or inefficiencies from future expenses as it could result in the recognition of gains and losses that would subsequently be reversed when experience unwinds. Instead, they favoured an entity specific approach for all variables that did not have observable market prices to be compared against.

Some IASB members observed that, in several cases, a market participant would be likely to use the entity's own assumptions when estimating future expenses, and that a market consistency adjustment that would make CFV and CEP different would be required only in a relatively small number of cases.

Explicit current estimate of expected cash flows and discounting

There was strong consensus in favour of introducing the requirement for a current, explicit, unbiased and probability weighted estimate of cash flows. This decision would have a significant impact on those businesses which have not yet adopted a probability weighted approach to financial projections. This is also likely to have an impact on insurance systems as pricing based cash flows and assumptions would have to be available for financial reporting purposes.

The IASB agreed that the current estimate will be prospective and will utilise the insurer's current views of the contract and its future rather than views that were set at the time of inception or pricing.

The decision to require discounting of all cash flows included in the current estimate was unanimous. The IASB discussed the possibility of using a current estimate with no discounting and no margin for non-life claims liabilities and tentatively decided not to consider this option in the development of the new IFRS.

As we noted earlier, the IASB has not yet discussed the attributes that need to be considered in choosing discount rates. Attributes include:

- currency and duration of cash flows;
- liquidity;
- credit characteristics (at a contract level, so more relevant to wholesale insurance products than to retail insurance contracts where policyholder protections exist); and, where appropriate,
- features of the assets backing specific liabilities (e.g. for insurance contracts where the liability cash flows are linked to the value of the assets backing them).

Reporting an explicit margin

The tentative decision to require the reporting of an explicit margin in the new IFRS brought to the table a discussion relating to five different possible approaches (see appendix), although no specific decision was made. Furthermore, the lack of consensus around the measurement objective means the IASB staff will continue to develop papers, to be discussed at future IASB meetings, with reference to all the proposed approaches. In addition, the unearned premium approach for the pre-claim liability of certain short-term/short-tail contracts will be discussed at future meetings.

There was strong consensus in favour of introducing the requirement for a current, explicit, unbiased and probability weighted estimate of cash flows.

The five possible approaches considered for determining the explicit margin were:

1. Current exit price (CEP) as presented in the 2007 Discussion Paper;
2. CEP as 1 above plus a prohibition to recognise an accounting day one profit;
3. Current fulfilment value (CFV) with a risk margin reflecting cost of bearing risk;
4. CFV as 3 above plus an additional margin calibrated to the premium at inception; and
5. CFV with a margin calibrated at inception to the premium.

Conclusions

The methodology underpinning the future Exposure Draft needs to encompass the requirements of both the IASB and FASB. It also needs to bridge the different members' perspectives on measurement, finding common ground on a number of complex issues.

The Boards will meet in London on 23 and 24 March 2009 for their first joint meeting of the year (two other joint meetings are scheduled for 23-24 July and 26-27 October). This will offer the Boards their first opportunity to "take stock" of their work on all joint projects. Particularly for the insurance project, the Boards can discuss their respective progress and consider other issues left open on the path to producing the first global GAAP for insurance. Our newsletters will keep you up-to-date on the developments at all these meetings.

Deloitte also has a number of recent more detailed informative documents relating to insurance accounting. In June 2007, Deloitte produced a summary of the IASB Discussion Paper; in September 2008, a document that considers the impact of IFRS on insurers especially those reporting on a US GAAP basis; in December 2008, an article on the similarities and differences between IFRS and Solvency II and in February 2009, an illustration of the current IFRS disclosure requirements for insurance companies writing both life and non-life contracts.

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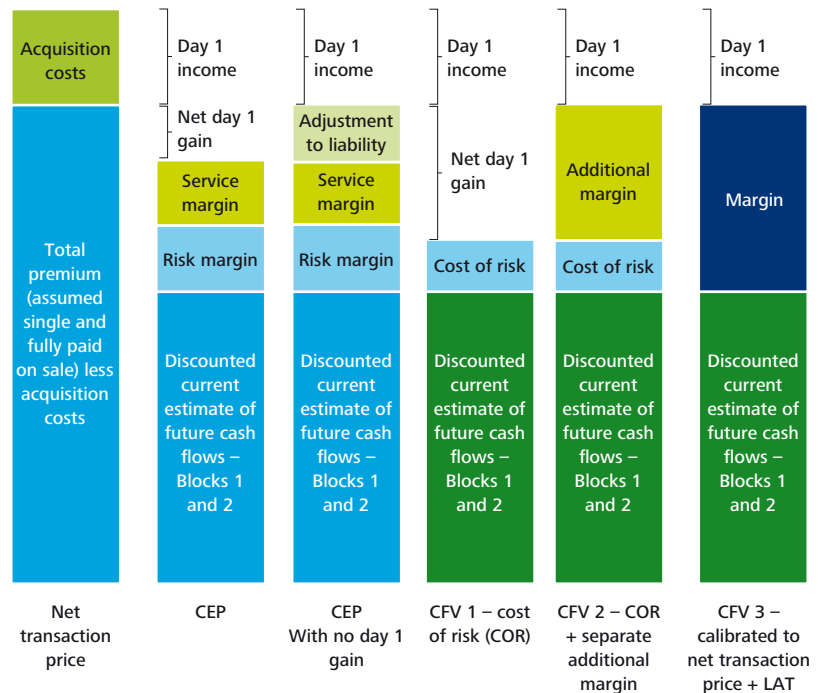
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Appendix

The IASB and FASB staff produced a tabular comparison of five measurement models ([Link to IASB February 2009 meeting observer notes](#)).

- Current exit price (CEP) as proposed by the discussion paper Preliminary Views on Insurance Contracts (DP).
- Current fulfilment value (CFV) including a risk margin reflecting the cost of bearing risk (CFV1).
- Current fulfilment value as in candidate 2 plus an additional separate margin, calibrated at inception to the premium (CFV2).
- Current fulfilment value including a single margin calibrated at inception to the premium (i.e. similar to candidate 3, but with one overall margin, not two separate margins) (CFV3).
- Unearned premium (only for the pre-claims liability of short-duration contracts).



In addition to these five options, the staff suggested considering a CEP model that uses an exit notion which prohibits recognising through profit or loss any positive day one difference. In this variant, the insurer would be required to treat any positive day one difference as an explicit separate adjustment to the insurance contract liability. The IASB and FASB staff explained that this adjustment is required “because of concerns on reliability and risk of error.”

During the Boards’ meetings it was clear that the unearned premium method would be of limited use and it may only feature as an approximation of the model the Boards would finally choose for the development of the new accounting standard. For this reason we do not comment on this model in the rest of this appendix.

We have illustrated how the two CEP models and the three CFV models would compare against a single premium fully paid insurance contract. In this diagram, we have also illustrated the possible decision to allow for a positive day one difference recognised in profit and loss to cover acquisition expenses incurred securing the insurance contract.

This matter has not yet been discussed by the Boards but the treatment illustrated was included in the IASB and FASB staff papers presented at the Boards’ meetings.

- Block 1 is the current estimate of future cash flows. Block 2 represents the discounting to reflect time value of money. The sum of blocks 1 and 2 is the discounted current estimate of future cash flows.
- In the case of the CFV approach, the estimate of variables that cannot be directly observed from a market price is determined using entity specific assumptions. This is not the case for the CEP approach, which is why the respective “discounted current estimate” bear a different colour. At the IASB meeting it was acknowledged that, in many cases, the market consistent view of those variables would be the same as the entity-specific one. However efficiency/inefficiency adjustments would be required to bring the estimate of an efficient/inefficient insurer in line with market participants’ estimates.
- The illustration shows cost of risk being lower than the risk margin. The IASB and FASB staff have not yet articulated whether that is the case. It is possible that further research in this area would result in acceptance that the two concepts result in substantially the same measurement. The IASB and FASB staff paper defined the risk margin under the CEP model as “the compensation required by market participants for bearing risk”. The cost of risk under the CFV models 1 and 2 was defined as “the cost of bearing risk, measured from an entity’s perspective”.
- The requirement to calibrate the initial measurement to the premium under CFV3 is combined with a requirement to test the initial measurement of the liability for adequacy. The test is not required subsequently because the CFV3 model would reflect any emerging losses via the updated discounted current estimate of future cash flows. Under the CFV2 model there is recognition of an additional margin liability only when the difference from the net transaction cost is positive. A negative difference would be recognised immediately through profit or loss with a liability equal to the discounted current estimate of future cash flows and a margin for the cost of risk.
- Calibration to a single fully paid premium is a relatively easy exercise. However the IASB and the FASB have not yet discussed the calibration approach to insurance contracts where the premium is due by instalments payable over several years and where the policyholder has the right to increase or reduce premiums under the terms of the contract (e.g. universal life-type contracts). This debate will take place when the principle to account for renewal/ cancellation options is agreed.

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